

MR. MADRICK: Thank you very much. It's a pleasure to be here, and it's a pleasure to hear that Roger reminded us that high tech stocks occasionally do go down.

I'm going to speak a little bit about those kinds of issues because I think in good times particularly, we get a very narrow consensus about issues, and it concerns me quite a bit. I'm going to speak a little bit overly provocatively.

I think this subject does raise deeply felt concerns, and sometimes I think we forget about this. Perhaps it is because of its very complexity. I think we can get away with some things because of this complexity, and maybe there are some more devious reasons behind it. I remain ingenuous about that issue, but economic theory if applied unconditionally often loses the forest for the trees.

Let me talk about one thing that concerns me, or I should say bugs me, I guess. The frequent use of simple accounting identities in this kind of analysis, with all due respect to everybody here, they are useful, theoretical, and pedagogical devices. They line most of our principal's textbooks, but they can be quite misleading.

The most frequently cited, as all of you know and I guess we've all cited, is that investment

always equals savings, I equals "S." This is always true at the end of the day, but it doesn't tell us that much about what happens during the day.

The simple fact is that such conceptual tools tell us little concrete about causal relationships. Does an increase in savings automatically mean that investment will rise? No, of course not.

Today, and again with due respect to my colleagues, we also hear a lot about how the current account deficit is merely a reflection of American economic might. International investors are so eager to invest in the U.S. that it raises the value of the dollar, and all of you know, indeed, better than I the mechanisms by which this works.

A trade and current account deficit become virtually or should we say merely inevitable. Current account deficit always equals the inflow of capital, another accounting identity.

But as some of us have been reminded today, we must also keep in mind that much of that capital inflow may be going to speculative and highly volatile stock markets or at least the bond markets, as Roger reminds us, that somehow relate to that, and they may flee the nation on a split second's notice. Then where do we stand?

Much of that capital inflow is also in search of a trustworthy reserve currency because there is nowhere else to put your money in the world, at least at the moment. That, too, can change quickly.

Let us keep most firmly in mind that capital flees a lot faster than trade deficits adjust. When capital flees, the current account deficit won't adjust as rapidly. Rapidly and damaging adjustments in the dollar and interest rates will have to compensate.

And finally, let us also keep in mind that the evidence is pretty clear, I think, and I doubt too that many of you disagree, America's propensity to import has remained very high. We like foreign goods more than foreigners like ours.

Whether international investors want to put their money here or not, the trade deficit under any theoretical construction is not due completely to the current and perhaps temporary popularity of American investment.

And some, and I abbreviate here, of course, know the current account deficit is not a simple reflection of America's economic strength. It is a complete issue.

In general, as you might suspect, my view is that a current account deficit is neither sustainable indefinitely nor generally good for

America. That is the kind of account deficit we have today, which is rising faster than GDP.

This doesn't mean a deficit is always bad.

At times of full or nearly full employment buying goods from overseas is beneficial. We can't press our capacity to produce too much further I don't think.

Also, America's trade deficit has been a boon to the rest of the world. We are the big engine that could. We probably bequeath the world nothing more important than access to our extraordinary marketplace.

Over time, however, I believe a persistent and, indeed, growing current account deficit is harmful. First, I do subscribe to the view that the net international investment position that results from a current account imbalance that grows faster than the GDP is both costly and ultimately dangerous. The Commission, I think, by now has been well supplied with the data. I won't bother to add anything to that.

It is costly. This position is costly because we pay interest on it and dividends. The assets themselves also represent a stock obligation for the U.S., and there is no theory that can tell us just when an investment overhang may result in a loss of confidence in the American markets.

But as the obligations grow, it becomes clear that investors may someday, and it could be soon, demand higher interest rates to compensate for growing risk. Foreign investors may, in particular, get jumpy.

Much of the latest capital inflow may well be hot money by definition. Some will not renew their loans. American investors, too, may seek greener pastures. All of this is further complicated at the moment by a high and speculative stock market.

If stock prices begin to fall seriously, foreign and American investors may put some of their money elsewhere. The danger is clear. A virtuous circle could turn into a vicious circle. I don't think I have to go too much farther to explain that.

My main point here is that because there are high and growing international asset positions and the high level of the dollar and the high level of the stock market -- and I am trying to talk as plainly as possible because this is exactly what I mean by missing the forest for the trees -- we don't need a large dislocation to cause a calamity. These markets don't need a calamity to start a calamity.

Falling stock prices due to a few disappointing earnings reports could at first trigger a modest capital flight. This could escalate. The

dollar falls. The Fed. worries about inflation. The Fed. tightens. Rates go up. Recession ensues. The vicious circle.

Am I forecasting that? No. Do I think it's a possibility? Yes. Do I think unforecastable things occur? I certainly do.

My second point is not sufficiently addressed. The odd equilibrium point we have reached between a high trade deficit and a high dollar has led to a misallocation of resources in the U.S. We don't talk about this very much.

Exports are chronically expensive on world markets. Investment in export industries is, therefore, dampened and productivity gains in these industries are suppressed.

As important, the high dollar makes investment in potential new export industries as well as in import substitution industries where prices are particularly low all the more difficult.

I don't know how we judge that export performance has been very strong. It seems to me more a matter of opinion than anything else. I think there's a fundamental reason, because of the overvalued dollar, to think there is a bias against serious investment in these industries.

It's disguised by our prosperity. It's disguised by growing productivity in the manufacturing industries, but let me remind you that until recently manufacturing industries in America grew quite slowly. They grew slowly in an economy that was growing slowly.

So we had some kind of triage. The companies and industries that remain produced high manufacturing, high productivity growth because they were competing overseas, but a lot of companies and industries did not remain. We have to be able to see what could be, not merely what has been.

Third, and related to the second, all else equal, let's not forget that it is better at least for America to buy goods at home. At some point in the future we will not be operating at full employment again. At that point we will feel more deeply every percentage point in the trade deficit.

That persistently high dollar dampens investment in industries that could, indeed, help us in the future. My most fervent wish is for a soft landing for the dollar. If the rest of the world starts to grow faster and America's economy slows, we may be able to adjust sufficiently to reduce the current account imbalance and win ourselves some reprieve from the rapidly mounting net international investment position.

As I said, the danger is that a modest adjustment turns into a large and damaging one. As for trade policy, I remain a fairly committed free trader for most of the conventional reasons, but I also believe in one less conventional reason that, indeed, goes back to Adam Smith. Large markets make for better productivity. Large markets allow you to specialize in labor, specialize in production, reach economies of scale, and the best way to increase large markets, and I don't mean only for manufacturers, but also for services, is to keep markets growing even larger.

In my view, economically and historically, the main advantage America had in the world and the reason it has always grown faster than everybody else is because it had that one currency, no-tariff, one-language market.

Nevertheless, if unfair trade practices against the U.S. are documentable, I think they should be pursued. I don't think it's going to solve the problem. The persistently high dollar is what's damaging our export industries.

Let me remind us of one other thing. Raising savings rates usually means a slower economy, and as Gerry discussed earlier, we don't have too much leeway in how we slow down economies. It can easily turn into recession.

When we talk about how we have to raise the savings rate, let's keep in mind very clearly that often means slow growth.

My final point is this, and I sharply disagree with many people discussing this issue today.

If we have a soft landing on the dollar, we buy ourselves time, but what do we buy ourselves time to do?

We should be buying ourselves time to keep increasing our productivity, maybe to improve our export industries. I undoubtedly agree that tax cuts are the wrong way to go on this, but I also believe at least for the most part that reducing our debt obligations are wrong also.

The way to grow in a new economy, and even I believe that to some degree there is a new economy, is intelligent use of public investment. That's the deficit in America today.

It's education that we need. It's research. It's all kinds of public goods that we have neglected, indeed, forgotten about in our current moment of prosperity. My guess is in the next five to ten years it will be quite obvious that we can't forget about that.

Thanks very much.

CHAIRMAN D'AMATO: Thank you, Mr. Madrick.

Secretary Truman.